BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendrayer	Chair
Marshall Johnson	Commissioner
Ken Nickolai	Commissioner
Thomas Pugh	Commissioner
Phyllis A. Reha	Commissioner

In the Matter of a Petition by CenterPoint Energy Minnegasco to Allow the Use of Forward Futures Contracts and Put Options in Combination with Call Options to Form a Collar and for a Variance to Minnesota Rules, Parts 7825.2400, 7825.2500 and 7825.2700 to Allow Recovery of the Costs of Those Instruments in the Purchased Gas Adjustment

ISSUE DATE: November 3, 2004

DOCKET NO. G-008/M-04-368

ORDER GRANTING VARIANCE TO MINN. RULES, PARTS 7825.2400, 7825.2500, AND 7825.2700

PROCEDURAL HISTORY

On March 5, 2004, CenterPoint Energy Minnegasco (Minnegasco) proposed a strategy for minimizing the effect of gas price changes on Minnesota customers ("hedging"), and asked the Commission to vary its Purchased Gas Adjustment (PGA) rules to allow Minnegasco to recover from ratepayers, on a monthly basis, the costs of implementing this strategy.

On April 5, 2004, the Minnesota Department of Commerce (the Department) recommended that the Commission grant the requested variance with conditions. Specifically, the Department recommended that the Commission limit the financial hedging to 10 percent of Minnegasco's annual cost for "firm" gas supply, and to deny Minnegasco's request to recover interest costs through the PGA mechanism.

On April 15, 2004, Minnegasco filed reply comments taking issue with the Department's recommended changes.

On April 30, 2004, the Department filed supplemental comments reaffirming its recommendations.

The Commission met on September 28, 2004, to consider this matter.

FINDINGS AND CONCLUSIONS

I. Late-Filed Comments

Commission rules generally provide for parties to file initial and reply comments in response to filings. Minn. Rules, part 7829.1400. However, the Commission may receive additional comments when further information would be required to make a fully-informed decision. Minn. Rules, part 7829.1400, subp. 5.

The Department filed supplemental comments in response to Minnegasco's reply comments, clarifying issues raised by Minnegasco. While Commission rules do not provide for supplemental comments, no party has alleged to have been prejudiced by them or opposed accepting them into the record of the case. Finding the supplementary comments necessary to the full understanding of the issues, the Commission will accept them.

II. Background

A. Purchased Gas Adjustments

Generally a public energy utility may not change the rates that it charges for service unless it undergoes a rate case wherein all of its costs and revenues are considered. But the Legislature has created exceptions to this general policy. For example, the Commission may permit an energy utility to adjust its rates outside the context of a general rate case to reflect changes in the cost of energy. Minn. Stat. § 216B.16, subd. 7.

Consistent with this statute, the Commission has adopted rules for implementing a "purchased gas adjustment" (PGA). See Minn. Rules, part 7825.2390 *et seq*. In particular, these rules permit a gas utility to make monthly adjustments for "changes in the commodity-delivered gas cost and demand-delivered gas cost for purchased gas...." Minn. Rules, part 7825.2500.B. The rules define the "cost of purchased gas" with respect to certain federally-prescribed accounts, plus "the normal and ordinary cost of injection and withdrawal of gas from storage...." Minn. Rules, part 7825.2400, subp. 12. The utility files a monthly PGA report justifying any rate adjustment, as well as filing an Annual Automatic Adjustment of Charges (AAA) report reconciling the costs and revenues for gas purchases throughout the entire year. Minn. Rules, part 7825.2700.

B. Hedging

Firm natural gas contracts typically specify the amount of gas to be delivered, where the gas should be delivered, and the formula for determining the price, generally based on index prices that change monthly. That is, standard contracts do not protect utilities or their customers from price fluctuations.

Minnegasco argues that consumers benefit from stable commodity prices, and that greater stability can be achieved through hedging transactions. For example –

- Minnegasco could lock in the price of gas to be delivered. Such a "forward futures contract" would entitle Minnegasco to receive a specified amount of gas at a specified price at a specified time; Minnegasco can then take possession of the gas or sell its right to do so to offset the cost of buying gas at prevailing market rates. Either way, ratepayers would avoid the harm of price increases above the contract price, but would also forgo the benefit of prices falling below the contract price.

- Minnegasco could buy an option to buy gas at a specified price in the future. Such a "call" option would protect ratepayers from the risk of prices rising above the option price. But unlike a forward futures contract, a call option would not preclude ratepayers from benefitting from declining gas prices.

- Minnegasco could sell an option to buy gas at a specified price in the future – that is, give another party the opportunity to compel Minnegasco to buy gas at a specified price in the future. The proceeds of such a “put” option would partially offset other gas costs.

- And Minnegasco could buy both a put and a call simultaneously. That is, Minnegasco could buy an option to buy a specified amount of gas on a specified date at a specified “ceiling” price, and sell the option to buy the same amount of gas on the same date at a lower “floor” price. Such a “collar” arrangement would permit Minnegasco to limit its exposure to the risk that prices would increase above the call option price, while deriving some revenues from the put option.

Whatever the benefits of these arrangements, however, the language of the Commission’s rules do not provide for Minnegasco to recover the cost of options or similar transactions through the PGA.

The Commission previously varied its PGA rules to permit Minnegasco to pursue a type of hedging. Gas utilities enter into firm contracts for gas that they agree to buy without contingency. And gas utilities buy “swing” contracts to reserve the option of buying additional gas in the event that, for example, demand increases because the weather is colder than anticipated on a given day. Minnegasco recovers the cost of both these contracts through the PGA. The Commission authorized Minnegasco to recover the cost of call options through the PGA where they would be cheaper than the reservation fee for a daily-priced swing contract.[1] But in general call options have proven to be more expensive than the comparable swing contracts, rendering the variance moot.

III. Substantive Issues

On March 3, 2004, Minnegasco asked the Commission to vary its rules. The Department supports some aspects of Minnegasco’s request and opposes others. The relevant issues, and the Commission’s decisions, are set forth below:

A. Variance Generally

1. Party Positions

Minnegasco asks the Commission to vary certain rules to permit Minnegasco to recover through the PGA mechanism costs related to gains and losses on forward futures contracts, puts, calls, basis differences, and certain transaction costs including interest on margin calls, brokers fees and option premiums.

The Department supports granting the necessary variances to allow Minnegasco to better manage gas price volatility. Minnegasco and the Department argue that the public interest is served if gas prices can be stabilized at reasonable cost. In contrast, enforcing Commission rules as written would deprive Minnegasco of the opportunity to recover hedging costs on the same basis as other

---

[1] *In the Matter of the Petition of Reliant Energy Minnegasco, a Division of Reliant Energy Resources Corp., for a Variance to Recover the Costs Associated With Financial Call Options Through the Purchased Gas Adjustment*, Docket No. G-008/M-01-540 ORDER GRANTING VARIANCE TO MINN. RULES, PARTS 7825.2400, 7825.2500, AND 7825.2700 (June 29, 2001).

gas costs, according to the Department and Minnegasco, creating a disincentive for Minnegasco to pursue such activities. Consequently the Department and Minnegasco agree on the general proposition that a variance is warranted, although they differed about some details.

2. Commission Action

Under Minnesota Rules part 7829.3200 the Commission may vary any of its rules upon findings that –

- enforcement of the rule would impose an excessive burden upon the applicant or others affected by the rule,

- granting the variance would not adversely affect the public interest, and

- granting the variance would not conflict with standards imposed by law.

Minnesota Rules part 7825.2390 *et seq*. are well-crafted to ensure that the PGA represents a narrow exception to the general policy that rates should be set through rate cases, after consideration of all costs and revenues. The rules' rigor prevents utilities from recovering costs through the PGA that are already being recovered through base rates. But the rules did not anticipate how hedging transactions could reduce the volatility of prices passed through to ratepayers or how price stability would serve the public interest.

The Commission finds that price stability does serve the public interest. To the extent that the Commission's rules create an disincentive for Minnegasco to engage in prudent policies to promote price stability, they impose an excessive burden on Minnegasco and its customers. Varying such rules to encourage Minnegasco's hedging activities will not harm the public interest, but rather will promote it. Finally, the Commission finds no legal standard prohibiting the variance of these rules. Having reviewed the record of this case and heard the arguments of the parties, the Commission will grant a variance to its rules as set forth below.

B. Timing and Duration

1. Party Positions

Minnegasco asks the Commission to vary its rules regarding transactions entered into by June 30, 2008, with the understanding that the variance would not apply to hedging transactions that exceeded 24 months in duration. Minnegasco states that the Commission has previously granted variances of similar duration.[2] Also, Minnegasco argues that there are administrative efficiencies to extending the variance through the end of a heating season; by industry convention, the "gas year" ends on June 30.

---

[2] See *In the Matter of the Petition of Aquila, Inc. for Variances to Minnesota Rules 7825.2400, 7825.2500 and 7825.2700 to Allow Recover of the Cost of Using Financial Instruments Through the Purchased Gas Adjustment*, Docket No. G-007, 011/M-03-821 ORDER GRANTING VARIANCES (October 13, 2003); *In the Matter of the Petition of Northern States Power Company d/b/a Xcel Energy for Approval of an Extension of Rule Variances to Recover the Cost of Financial Instruments Through the Purchased Gas Adjustment Clause*, Docket No. G-002/M-03-1627 ORDER EXTENDING VARIANCE WITH CONDITIONS (January 23, 2004).

The Department supports Minnegasco's request to vary the Commission's rules regarding prudent contracts that Minnegasco enters into by June 30, 2008. The Department notes that granting this request would not deprive the Commission of the power to disallow recovery of imprudently-incurred costs or to revoke the variance prospectively, should the need arise.

2. Commission Action

Having reviewed the position of the parties, the Commission finds the proposed variance's timing and duration to be reasonable and will therefore approve them.

C. Hedge Cap

1. Party Positions

To limit the magnitude of any risk resulting from the requested variance, Minnegasco proposes that the variance apply to only 45 billion cubic feet (Bcf) of gas per year, or roughly 31% of Minnegasco's total throughput. Minnegasco forecasts that it will not gain or lose more than $2 per decatherm (Dkt) purchases through a forward futures contract, and consequently its proposed hedging strategy would likely change total gas costs by less than 10%.

As noted above, the Department supports varying the PGA rules. But Minnegasco's limited experience with hedging – especially multi-year hedging contracts – prompts the Department to recommend limiting the waiver to encompass only 10% of Minnegasco's firm gas purchases. Based on Minnegasco's 2003 gas purchases, the Department estimates that a 10% cap would permit Minnegasco to recover $51.5 million in hedging transactions through the PGA.

2. Commission Action

Minnegasco identifies multiple purposes for its variance request. The Commission concludes that different purposes warrant different regulatory safeguards.

First, the Commission has already authorized Minnegasco, without limit, to use the PGA to recover the cost of calls where they can be used in place of a more-expensive swing gas contract. But Minnegasco reports that call contracts are typically too expensive. Instead, Minnegasco proposes to use both puts and calls as a substitute for swing gas contracts; where the proceeds of the put contract subsidizes the cost of the call contract, the combined transaction may be less expensive than a comparable swing gas contract. The Department had no opposition to this proposal so long as the put contract is used only in conjunction with a call contract to form a collar. The Commission finds this proposal reasonable, and sees little risk to ratepayers. Where Minnegasco uses a collar in lieu of a more-expensive swing gas contract, ratepayer interest is largely protected. Therefore, no cap is required for such transactions.

Where forward futures contracts are concerned, however, the Commission is persuaded that some cap should be in place to limit ratepayer exposure to unforeseen problems. But Minnegasco and the Department disagree about the appropriate size of the annual cap and whether the cap should be based on total gas purchases or merely firm gas purchases. Moreover, setting annual limits can be problematic because some contracts may extend for multiple years, and the heating year in which a contract is adopted may be different from the heating year in which a contract is fulfilled. Consequently, the Commission will decline to adopt either party's proposal for setting an annual cap for Minnegasco's variance.

Instead, the Commission will limit the variance to permit Minnegasco to recover hedging costs related to transactions involving no more than 26 Bcf of gas at any one time. Assuming Minnegasco will lose no more than $2 per Dkt of gas purchased through a forward futures contract, and that each Dkt represents roughly 1000 cubic feet of gas, a $51.5 million cap would limit Minnegasco to roughly 26 Bcf of gas hedged.[3] A cap on the amount of hedged gas under contract at any given moment is clearer than an annual cap and should be easier to administer.

That said, the Commission will adopt the Department's recommendation to further limit the amount of multi-year contract costs that Minnegasco may recover through the PGA. Given the added degree of risk these contracts involve, the Commission concludes that only 10% of the net hedging costs that Minnegasco recovers through the PGA should reflect multi-year contract costs.

D. Carrying Costs

1. Party Positions

In addition to seeking to recover the cost of hedging transactions through the PGA, Minnegasco also asked to be allowed to recover through the PGA the cost of financing these transactions, including interest costs related to margin calls. In the spring, for example, Minnegasco may buy an option for gas to be consumed in the winter. Minnegasco would need to incur the cost of the option immediately, but would not be able to recover the option's cost until the underlying gas was consumed in the winter. Minnegasco argued that, in the absence of the ability to recover the cost of the capital used during this period, Minnegasco would have a disincentive to purchase the option.

Consistent with its prior position on such matters,[4] the Department opposes this request. The PGA was not intended to recover capital costs, the Department argues. The Department questions why Minnegasco should be permitted to recover carrying costs related to buying a futures contract for gas through the PGA, but not carrying costs when Minnegasco actually purchases gas for its own storage. Minnegasco's rates were designed to provide Minnegasco with sufficient revenues to finance ongoing operations, according to the Department; permitting Minnegasco to recover carrying costs again though the PGA would allow Minnegasco to recover such costs twice.

2. Commission Action

Having reviewed the position of the parties, the Commission finds merit in the Department's comments and will decline to permit Minnegasco to recover carrying costs through the PGA.

---

[3] [$51,500,000 /($2/Dkt)] x 1000 c.f./Dkt = 25,750,000,000 c.f.

[4] See Department comments in Docket No. G-002/M-03-1627 *In the Matter of the Petition of Northern States Power Company d/b/a Xcel Energy for Approval of an Extension of Rule Variances to Recover the Cost of Financial Instruments Through the Purchased Gas Adjustment Clause.* Northern States Power Company ultimately abandoned its efforts to recover carrying costs through the PGA. See *id.*, ORDER EXTENDING VARIANCE WITH CONDITIONS (January 23, 2004) at 5.

E. Reporting Requirements

1. Party Positions

As a condition of receiving a variance from Commission rules, Minnegasco proposes to make the following reports to the Commission:

In its request to approve changes in demand entitlements,[5] Minnegasco proposes to describe the changes to its current supply portfolio necessary to meet firm requirements for the coming heating season. This description would include a list of all financial instrument arrangements entered into for the coming heating season. The list would contain the relevant terms for each contract, including the cost associated with the contract (premium), size of the contract (in Dkt/day), date entered into, the price assigned to the contract, and an explanation of the benefits of these activities to Minnegasco's ratepayers.

In a schedule in its monthly PGA filing,[6] Minnegasco proposes to separately identify the amount of financial instrument costs included in the calculation of the demand costs recovery rate for the month.

In its Annual Automatic Adjustment report,[7] Minnegasco proposes to include data on the specifics of any price hedging contracts, including 1) a list of each hedging contract entered into, 2) the total Dkt contracted for in each instrument, and 3) the net gain or loss, including all transaction costs.

The Department supports this proposal.

2. Commission Action

Having reviewed the position of the parties, the Commission finds the proposed reporting requirements to be reasonable and will therefore approve them.

The Commission will so order.

ORDER

1. The supplemental comments of the Minnesota Department of Commerce are accepted.

2. Minnesota Rules parts 7825.2400, 7825.2500, and 7825.2700 are varied to permit Minnegasco to recover through the PGA the cost of forward futures contracts, and put options in combination with call options to form a collar, entered into by June 30, 2008, that have a duration of no more than 24 months, as follows:

---

[5] See Minn. Rules part 7825.2910, subp. 2.

[6] See Minn. Rules part 7825.2910, subp. 1.

[7] See Minn. Rules part 7825.2810.

- Minnegasco may recover through the PGA the cost of collars used to hedge daily-priced swing contracts. In addition, Minnegasco may recover through the PGA the cost of forward futures contracts for up to 26 bcf of gas at any given time, provided that no more than 10% of the net costs reflect the cost of multi-year contracts.

- Minnegasco may not recover the interest costs related to margin calls through the purchased gas adjustment mechanism.

3. Minnegasco shall report to the Commission as follows:

   - In its request to approve changes in demand entitlements, Minnegasco shall describe the changes to its current supply portfolio necessary to meet firm requirements for the coming heating season. This description shall include a list of all financial instrument arrangements entered into for the coming heating season. The list shall contain the relevant terms for each contract, including the cost associated with the contract (premium), size of the contract (in Dkt/day), date entered into, the price assigned to the contract, and an explanation of the benefits of these activities to Minnegasco's ratepayers.

   - In a schedule in its monthly PGA filing, Minnegasco shall separately identify the amount of financial instrument costs included in the calculation of the demand costs recovery rate.

   - In its Annual Automatic Adjustment report, Minnegasco shall include data on the specifics of any price hedging contracts, including 1) a list of each hedging contract entered into, 2) the total Dkt contracted for in each instrument, and 3) the net gain or loss, including all transaction costs.

4. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

This document can be made available in alternative formats (i.e., large print or audio tape) by calling (651) 297-4596 (voice), (651) 297-1200 (TTY), or 1-800-627-3529 (TTY relay service).